

GLORIA L. FRANKLIN, CLERK
U.S. BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA



The following constitutes
the order of the court. Signed March 26, 2007

Marilyn Morgan
Marilyn Morgan
U.S. Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

In re:

**SONICBLUE INCORPORATED,
DIAMOND MULTIMEDIA SYSTEMS,
INC., REPLAYTV, INC., and SENSORY
SCIENCE CORPORATION,**

Debtors.

Cases No. 03-51775, 03-51776,
03-51777, and 03-51778-MM

Chapter 11 cases
Jointly administered

**MEMORANDUM DECISION AND
ORDER ON MOTION TO APPOINT A
CHAPTER 11 TRUSTEE, MOTION TO
CONVERT CASE, AND MOTION TO
DISQUALIFY PILLSBURY WINTHROP
SHAW PITTMAN LLP AND FOR
DISGORGEMENT OF ATTORNEYS'
FEES**

INTRODUCTION

When claims traders entered this case and started asking hard questions, circumstances came to light that implicated at least debtor's counsel, committee counsel and certain members of the committee, and resulted in the complete breakdown of creditor confidence. The genesis of the problem arose from the pre-petition issuance of an opinion letter, undisclosed by debtor's counsel, assuring payment to certain bondholders who effectively controlled the creditors' committee. Years later, when debtor's counsel objected to these bondholders' claims because of an original issue discount approximating \$43

1 million, the bondholders demanded indemnification from the law firm. The problem was compounded
2 when debtor's counsel attempted to solve its disabling conflict by "handing off" these claims objections
3 to committee counsel, who accepted the awkward assignment. Incredibly, these same bondholders
4 somehow were also able to insert a provision in the settlement of estate litigation without disclosing that
5 it arguably may provide them with millions more in distributions, at the expense of general unsecured
6 creditors.

7 A more complete statement of the background is set forth below in the analysis of the motions
8 by the United States Trustee to disqualify Pillsbury Winthrop Shaw Pittman LLC as counsel for the
9 debtor and for disgorgement of attorneys' fees, its motion for the appointment of a chapter 11 trustee,
10 and the motion of SONICblue Claims, LLC for conversion of the case to one under chapter 7. For the
11 reasons explained, the motion for disqualification is granted, and the court finds that the appointment
12 of a chapter 11 trustee is warranted as being in the best interests of the creditors and other interested
13 parties.

14

15 **FACTUAL BACKGROUND**

16 *Formation of Joint Venture*

17 SONICblue Incorporated and three operating subsidiaries, Diamond Multimedia Systems, Inc.,
18 ReplayTV, Inc., and Sensory Science Corporation (collectively, SONICblue), designed and marketed
19 consumer electronic products. Pillsbury Winthrop Shaw Pittman LLP ("PWSP") served as
20 SONICblue's longtime general corporate and litigation counsel. On January 3, 2001, SONICblue
21 formed S3 Graphics Co., Ltd., a joint venture with VIA Technologies, Inc., to operate SONICblue's
22 graphics chip business. Among the assets that SONICblue contributed to the joint venture was its
23 graphics intellectual property, specifically including rights under a 1998 patent cross-license with Intel
24 Corporation. The rights to use Intel's graphics patents were so important that the joint venture
25 agreement included a liquidated damages clause at article 5.6 entitling the joint venture and VIA each
26 to damages of up to \$70 million if the joint venture were ever enjoined from using the Intel cross-
27 license. From the inception of the joint venture, there were serious disputes, including the threat of
28 litigation, between SONICblue and VIA. In the context of settlement proposals in 2002, the parties

1 negotiated a \$15 million loan from VIA to SONICblue. However, neither a settlement nor the loan were
2 consummated pre-petition.

3 *Issuance of Senior Debentures and Related Opinion Letter by PWSP*

4 In April 2002, SONICblue raised financing in a private placement issuance of \$75 million in
5 7³/4% senior secured subordinated convertible debentures. Three institutional bondholders, Portside
6 Growth & Opportunity Fund Ltd., Smithfield Fiduciary LLC, and Citadel Equity Fund Ltd., acquired
7 the senior debentures at a discount for \$62.5 million. The senior debentures were also partially secured
8 by SONICblue's interest in shares of United Microelectronic Corporation ("UMC"), a Taiwanese
9 company. Importantly, the indenture provided for the subordination of the senior debentures to certain
10 obligations at Section 4.1:

11 The payment of the principal of, premium, if any, and interest on all Debentures
12 . . . issued hereunder shall, to the extent and in the manner hereinafter set forth, be
13 subordinated and subject in right of payment to the prior payment in full of all Senior
14 Indebtedness, whether outstanding at the date of this Indenture or thereafter incurred.

15 "Senior Indebtedness" was defined in Section 1.1 of the indenture:

16 "Senior Indebtedness" shall mean the principal of, premium, if any, interest on
17 . . . and any other payment due pursuant to any of the following, whether outstanding on
18 the date of this Indenture or thereafter incurred or created:

19 * * *

20 (g) All indebtedness of the Company due and owing to Via Technologies,
21 Inc. in an aggregate principal amount not to exceed \$15,000,000 or the equivalent
22 thereof in any other currency or composite currency (the "Via Indebtedness");
23 Existing debentures in the amount of \$100 million issued in 1996 were also subordinated to the senior
24 debentures. PWSP partner Jorge del Calvo was designated for notice purposes on the indenture on
25 behalf of SONICblue.

26 In its capacity as counsel to SONICblue, on April 22, 2002, PWSP issued to the senior
27 bondholders a written opinion as to the enforceability of the debentures. This opinion letter reads in
28 pertinent part:

29 2. . . Each of . . . the Purchase Agreement, the Registration Rights Agreement, the
30 Indenture, the Pledge and Security Agreement and the Option Agreement, when duly
31 executed and delivered by the Buyers, will each constitute a valid and binding agreement
32 of the Company, enforceable against the Company in accordance with its terms.

1

* * *

2

3. The issuance and sale of the Debentures have been duly authorized. Upon
4 issuance and delivery against payment therefor in accordance with the terms of the
5 Indenture and the Purchase Agreement, the Debentures will constitute valid and binding
6 obligations of the Company, enforceable against the Company in accordance with their
7 terms.

8

* * *

9

10 9. . . (b) Our opinion in paragraph 2 above is subject to and limited by (i) the
11 effect of applicable bankruptcy, insolvency, reorganization, fraudulent
12 conveyance, receivership, conservatorship, arrangement, moratorium or other
13 laws affecting or relating to the rights of creditors generally. . . .

14 In what may have been a scrivener's error, the bankruptcy limitation in paragraph 9 referenced only
15 paragraph 2 and not paragraph 3 of the opinion letter.

16

Chapter 11 Filing and PWSP's Bankruptcy Rule 2014 Disclosures

17

18 Just six months after the issuance of the senior debentures, SONICblue was unable to meet its
19 maturing financial obligations and entered into a retainer agreement for PWSP to "represent it in its
20 effort to restructure its obligations to certain of its existing . . . debt The Firm's engagement will
21 also include representation of SONICblue in . . . any case prosecuted under Title 11 of the United States
22 Code" PWSP partner Jorge Del Calvo was copied on the retainer letter. SONICblue and the
23 subsidiaries filed chapter 11 petitions on March 21, 2003. While the cases are jointly administered, they
24 have not been substantively consolidated.

25

26 On April 11, 2003, PWSP filed an employment application accompanied by a verified statement
27 pursuant to Bankruptcy Rule 2014, which disclosed:

28

29 3. The Firm has been engaged as the Debtors' corporate and litigation counsel since
30 approximately 1989. During that time, the Firm has provided legal
31 representation to the Debtors in a variety of areas, including corporate and
32 securities matters, mergers and acquisitions, litigation, and intellectual property
33 matters. The Firm has been working with the Debtors in connection with their
34 restructuring since approximately October 25, 2002 when the Firm was retained
35 to provide advice concerning the restructuring of the Debtor's liabilities and
36 business operations.

37

38 The disclosure continued as follows:

39

40 6. As discussed below, I, the Firm, and certain of its partners, counsel, and
41 associates may have in the past represented, and may presently and likely in the
42 future will represent creditors or stockholders of the Debtors in matters unrelated

1 to these Chapter 11 Cases. A preliminary conflicts search performed at my
2 direction discloses that the Firm may have represented or represents entities that
3 are involved in some capacity with one or more of the Debtors, or may have
4 some other relationships with these entities, in matters unrelated to the Debtors.
5 To the best of my knowledge, the Firm's relationships with these entities is as
6 follows. . . .

7 However, PWSP failed to disclose its connection resulting from the issuance of the opinion letter to the
8 senior bondholders one year earlier. It added, "The Firm will continue to monitor its relationship with
9 the creditors and other parties in interest in these cases and, as it discovers additional information
10 requiring disclosure, will promptly supplement this application with any appropriate disclosures." The
11 court appointed PWSP as counsel for the debtors. Marcus Smith, the Chief Financial Officer of
12 SONICblue, was designated its responsible individual. PWSP diligently filed supplemental disclosures
13 on May 30, 2003, January 23, 2004, October 27, 2004, July 13, 2005, July 27, 2005, November 4, 2005,
14 and June 5, 2006, none of which mentioned the opinion letter.

15 The Office of the United States Trustee appointed an Official Committee of Unsecured Creditors
16 on March 21, 2003. The court authorized the employment of Ron Bender of the law firm Levene,
17 Neale, Bender, Rankin & Brill LLP ("LNBRB") as counsel for the committee on April 11, 2003. As
18 originally constituted, the committee was comprised of eight members: Portside Growth and
19 Opportunity Fund, Ltd., Smithfield Fiduciary LLC and Citadel Equity Fund Ltd. (collectively, the
20 "senior bondholders"), represented by Bruce Bennett of Hennigan, Bennett & Dorman, Matsushita
21 Kotobuki Electronics Sales of America LLC and Matsushita Kotobuki Electronics Industries, A-Max
22 Technology Co. Ltd., Manufacturers' Service Limited, and Maxtor Corporation. In October 2003,
23 Baltrans Logistics Inc. replaced Maxtor Corporation on the committee. After the initial months of the
24 case, however, only the three senior bondholders and the two Matsushita companies remained active
25 in the cases, making the senior bondholders the majority voice on the committee. Including the
26 anticipated distribution collectable from the junior bondholders, the senior bondholders effectively
27 control approximately two-thirds of the claims in these cases.

28 Projecting that they would exhaust their cash reserves by April 20, 2003, the debtors
immediately sought and obtained court approval of the sales of their three operating businesses, the Go
Video, ReplayTV, and Rio product lines. Thereafter, these became liquidating chapter 11 cases.

1 Notably, there is no functioning board of directors to whom Smith reports. The debtor holds nearly \$80
2 million in funds for distribution and anticipates receiving an additional \$6 million from preference
3 settlements. Secured claims have been paid in full from the proceeds of sale, and a distribution of 33%
4 to unsecured creditors is anticipated.

5 *Breach of Fiduciary Action in Connection with Issuance of the Senior Debentures*

6 On April 21, 2005, some of the junior bondholders filed a complaint in the Superior Court for
7 Santa Clara County against Smith and former officers and directors of SONICblue, Kenneth Potashner,
8 John Todd, Terry Holdt, Edward Esber, Robert Lee and James Schraith. The junior bondholder
9 plaintiffs assert claims for breach of fiduciary duty and constructive fraud in connection with the
10 issuance of the senior debentures in 2002. They assert that the defendants improperly authorized and
11 entered into the financing arrangement while SONICblue was in the zone of insolvency and hopelessly
12 unable to honor its long-term bond obligations. They further assert that by pledging its UMC stock in
13 the transaction, SONICblue rendered a significant asset unavailable to junior bondholders in a
14 liquidation. The defendants removed the complaint to this court on June 14, 2005 on the basis that they
15 may have substantial claims for contribution and indemnification against the debtor. That adversary
16 proceeding, Adv. No. 05-5338, remains pending, though inactive.

17 *VIA Litigation and Settlement Negotiations*

18 VIA and S3 Graphics filed duplicate proofs of claim for \$70 million each on July 17, 2003 based
19 on a breach of the joint venture agreement. They assert the breach was caused by the failure to pay
20 certain accounts payable, offering non-ordinary course discounts to accelerate the collection of
21 receivables, wrongful retention of receivables collected on behalf of the joint venture, and the failure
22 to contribute certain assets to the joint venture, and they assert they are also entitled to liquidated
23 damages if enjoined prospectively from the use of the Intel cross-license. SONICblue objected to the
24 claims and filed an adversary complaint for affirmative relief on December 21, 2004 asserting that VIA
25 and S3 breached the joint venture agreement by failing to pay assumed obligations, that VIA breached
26 its fiduciary duty in the operations of the joint venture and the settlement of patent litigation with Intel,
27 and that S3 aided and abetted the breach of fiduciary duty. It sought compensatory and punitive
28 damages, equitable subordination of VIA's and S3's claims, restitution, and an accounting. PWSP

1 represented SONICblue in the VIA/S3 litigation.

2 SONICblue engaged in concurrent litigation with Intel Corporation concerning the termination
3 or assumption of the patent cross-license and the parties' respective rights. This litigation was also
4 significant because termination of the license would arguably trigger the liquidated damages provision
5 of the joint venture agreement. Because of PWSP's prior representation of Intel, the debtor retained
6 O'Melveny & Myers LLP as special litigation counsel to represent it in the dispute with Intel.

7 The various claims in the litigation with VIA and S3 and with Intel reportedly involved complex,
8 disputed facts. The declaration of Albert Boro, a PWSP partner, sets out the following chronology
9 concerning the litigation and related settlement negotiations. Settlement discussions between
10 SONICblue and VIA and S3 began in earnest on August 11, 2005 when the parties and their counsel
11 met to discuss a proposed structure for settlement. Following the initial meeting, counsel for
12 SONICblue participated in conference calls with special litigation counsel, LNBRB as committee
13 counsel, and Bennett as counsel for the senior bondholders. Based on those discussions, Boro concluded
14 that a global settlement that included Intel was necessary and that a settlement amount of less than \$25
15 million would be acceptable to the committee. Committee counsel authorized the debtor to counter with
16 a settlement offer of \$6 million. Bennett, as counsel for the senior bondholders, confirmed on August
17 30, 2005 that his clients would support a \$6 million counteroffer. Boro believed that the consent of the
18 senior bondholders to the terms of a settlement was essential to court approval.

19 On September 12, 2005, counsel for VIA sent to PWSP a draft settlement term sheet proposing
20 that VIA be allowed a general unsecured claim in the amount of \$27.5 million. In a subsequent
21 settlement meeting among counsel held on September 15, 2005, VIA and S3 reduced their settlement
22 demand to \$19 million. Bennett indicated that the senior bondholders would support a settlement of
23 only \$10 million. The debtor, through Smith, authorized a \$10 million counteroffer. It is unclear
24 whether the committee at large was consulted at this juncture or why debtor's counsel consulted only
25 Bennett. Counsel ultimately reached a tentative agreement as to a settlement amount of \$12.5 million,
26 subject to the approval of the respective clients and of creditors. The debtor, VIA, and S3 agreed
27 immediately to the settlement amount.

28 On September 20, 2005, Bennett confirmed the senior bondholders' agreement to a \$12.5 million

1 allowed claim, provided the settlement included, *inter alia*, that the allowed claim be neither senior nor
2 junior to other general unsecured claims. The allowed amount of the defendants' claim appears to have
3 been fixed by September 20, 2005. Again, the record is unclear whether the committee participated at
4 this stage other than through the senior bondholders. In a conference call among counsel that same day,
5 SONICblue accepted the settlement terms but requested language that the allowed claim be neither
6 senior nor junior to other general unsecured claims. There were further discussions that the allowed
7 claim of the defendants would be a general unsecured claim, would receive an anticipated distribution
8 in the bankruptcy case of approximately 25%, and would not have priority, yet would not be
9 subordinated relative to other general unsecured claims. Boro reports that counsel for VIA and S3
10 "posed questions about subordination of the claims of the Senior Noteholders and other creditors, and
11 expressed concern that other creditors not unduly benefit at their clients' expense, but they nevertheless
12 agreed that their [allowed] claim was neither senior nor junior to other general unsecured claims."

13 Boro's declaration reflects that at the time of the September 15, 2005 settlement meeting, he was
14 aware that the senior bondholders were subordinated to VIA Indebtedness under the terms of the
15 indenture. His declaration also reflects that, prior to September 20, 2005, he had formed the belief that
16 the VIA Indebtedness referred only to the proposed \$15 million loan to SONICblue that was never
17 made. On September 26, 2005, counsel for SONICblue and the defendants finalized a draft of the
18 proposed settlement term sheet, which included the following provision:

19 Claimants shall jointly hold a single, allowed general unsecured claim in the Chapter 11
20 case of SONICblue Inc., which claim shall be afforded the benefits and priority of
21 SONICblue's other allowed general unsecured claims and shall be neither senior nor
junior to any other allowed general unsecured claim, in the amount of \$12.5 million. .

22 Boro sent the proposed term sheet to Bennett and to LNBRB on September 27, 2005. In a conference
23 call held later that day, the committee approved the settlement terms. Bender stated in a declaration that
24 this proposed term sheet was the only document concerning the settlement terms that was provided to
25 committee counsel before it received the final settlement agreement.

26 Finalizing the settlement between SONICblue, VIA, and S3 was delayed and made complicated
27 by the difficulty in reaching a resolution with Intel over the parties' respective rights under the patent
28

1 cross-license. For that reason, the initial draft of a settlement agreement was not prepared until January
2 25, 2006, when SONICblue's special litigation counsel, O'Melveny & Myers, circulated a draft that
3 contained a provision dealing with VIA's allowed claim that read substantially the same as the one in
4 the September 26, 2005 term sheet. Boro stated in his declaration that, in April or early May 2006, he
5 and PWSP partner Thomas Loran proposed that the settlement agreement include language specifically
6 stating that the defendants' allowed claim was not "Senior Indebtedness" under the indenture for the
7 senior debentures. Purportedly, the reason the PWSP attorneys made the suggestion was to foreclose
8 future litigation over the priority of VIA and S3's allowed claim. They also believed that "VIA
9 Indebtedness" referred to the \$15 million loan that was never made.

10 On May 12, 2006, O'Melveny & Myers circulated a revised draft of the settlement agreement
11 with the following language added:

12 Claimants and the Debtor agree that the Allowed Claim is not, and shall not be treated
13 as, "Senior Indebtedness" under the terms of the Debtor's Indenture, dated as of April
22, 2002, for the 7-¾ Secured Senior Subordinated Convertible Debentures due 2005.

14 VIA agreed to the language waiving "Senior Indebtedness" status on June 1, 2006. Substantially the
15 same language was included in a later revised draft circulated on June 16, 2006 and in the final
16 settlement agreement.

17 *Objection to Claim of Senior Bondholders*

18 Since substantially all assets have been liquidated, PWSP has been prosecuting avoidance
19 actions and objections to claims. It has divided and shared the work with LNBRB, however, PWSP
20 retained the more complex litigation or litigation requiring some knowledge of the background of the
21 debtor's operations. PWSP initially examined the claims of the senior bondholders and the junior
22 bondholders. It expended 49.50 hours, incurring \$23,237.50 in legal fees, to complete its analysis of
23 the senior bondholders' claims, including research on the applicability of fraudulent transfer law and
24 usury law to the transaction. Based on its analysis, it identified a significant problem with the original
25 issue discount granted the bondholders, the difference between the face amount and the amount actually
26 paid for the debentures. The senior bondholders also received other consideration in the transaction,
27 including the UMC stock, that rendered the valuation of the original issue discount more complex.

1 SONICblue asserts that the original issue discount constituted unamortized interest as of the petition
2 date that is subject to disallowance under Bankruptcy Code § 502(b)(2). On July 20, 2006, PWSP
3 attorney Matthew Walker sent an email to Bennett setting forth his analysis of the original issue
4 discount and asserting that the bondholders' claim may be subject to partial disallowance under
5 § 502(b)(2) to the extent of any unmatured interest as of the petition date. Walker's analysis showed
6 an original issue discount of \$43 million. He closed with an invitation to engage in a dialogue to resolve
7 the matter short of formal litigation.

8 Bennett contacted PWSP partner Craig Barbarosh on August 24, 2006 to discuss SONICblue's
9 challenge to the bondholders' claim. He also brought to Barbarosh's attention that PWSP had issued
10 the opinion letter to the bondholders in connection with the issuance of the debentures. Bennett asserted
11 that the bondholders had relied on the opinion letter, which they interpreted as assuring that their claims
12 were allowable in a subsequent bankruptcy case. He further indicated that the bondholders would
13 demand that PWSP defend and indemnify them for any losses resulting from SONICblue's challenge
14 to their claim. Bennett's partner followed up on September 5, 2006 with a letter to the managing
15 partner of PWSP demanding indemnification from PWSP for any shortfall to which the senior
16 bondholders may be subjected as a result of SONICblue's objection to their claim. In the letter, he
17 indicated that to the extent the bondholders are unable to recover in the bankruptcy case the full
18 principal amount of the debentures, they intended to pursue PWSP for negligent misrepresentation and
19 negligence, among other claims.

20 Barbarosh asserts in his declaration that the telephone call on August 24, 2006 was the first time
21 he became aware of the April 22, 2002 opinion letter. PWSP immediately contacted counsel for the
22 committee, informed Bender of the bondholders' indemnification demand, and turned over to the
23 committee the task of prosecution of the objection to the claims of the senior bondholders. On
24 September 6, 2006, it forwarded its work file containing its analysis to LNBRB. PWSP did not,
25 however, file a supplemental Bankruptcy Rule 2014 disclosure to address the claim of the senior
26 bondholders. When it filed its eighth interim application for compensation with the court on October
27 18, 2006, PWSP did address the analysis of and potential objection to the claim of the senior
28 bondholders. However, it simply disclosed, "The matter was turned over to the Creditors' Committee

1 for prosecution.” PWSP partner Boro asserts in his declaration that he was unaware of any potential
2 or actual claim by the senior bondholders at the time he negotiated the language concerning the priority
3 and treatment of VIA’s allowed claim under the settlement between September 2005 and June 2006.

4 Approval of VIA Settlement

5 The VIA settlement agreement was filed under seal on October 10, 2006 with the debtor’s
6 motion to approve the settlement. Bender asserts that LNBRB first received the settlement agreement
7 a few days before it was filed with the court. Because the settlement agreement was lengthy and
8 complex and because LNBRB had not seen any prior drafts, it requested that debtor’s counsel verbally
9 walk LNBRB through the settlement agreement. In a conference call on October 4, 2006, Suzanne
10 Uhland of O’Melveny & Myers reviewed the document and the terms of the settlement agreement with
11 LNBRB partners Ron Bender and Craig Rankin. In a declaration, Bender states that there was no
12 discussion of the waiver in the settlement agreement of VIA’s “Senior Indebtedness” status under the
13 indenture. He also indicated that the committee was very pleased with the settlement because it had
14 been willing to settle the litigation for \$25 million. The court approved the VIA settlement on October
15 31, 2006.

16 Joint Disclosure Statement and Plan and Disclosure of Indemnification Demand Against PWSP

17 The debtors, in consultation with the committee, had determined for strategic reasons to defer
18 efforts in these cases to propose and confirm a plan of reorganization. The reasons included the
19 uncertainty posed by the significant claims of VIA and S3 on the confirmability of and distributions
20 under a plan, the potential rejection of the Intel cross-license at confirmation, giving rise to up to \$70
21 million in liquidated damages, and the desire to substantively consolidate the estates under a plan after
22 the VIA litigation was settled. The committee assumed the lead role in preparing the joint disclosure
23 statement and plan. The initial disclosure statement filed on December 15, 2006 disclosed PWSP’s
24 conflict as follows:

25 However, as a result of a conflict that has been asserted by the Senior Noteholders with
26 respect to counsel to the Debtors, the Creditors’ Committee is now in charge of analyzing
the Senior Notes Claims.

27 Upon the objection of creditors Riverside Contracting, LLC and Riverside Claims, LLC, the
28 disclosure statement was amended on January 18, 2007, elaborating on the description of the conflict

1 as follows:

2 [U]ntil recently, counsel to the Debtors was in charge of analyzing the Senior Notes
3 Claims. As a result of the Senior Noteholders' contention that counsel to the Debtors
4 had pre-petition issued to the Senior Noteholders an unqualified legal opinion that the
5 Senior Notes were enforceable against the Debtors in accordance with their terms,
6 counsel to the Debtors requested the Creditors' Committee to assume the role of
7 analyzing the Senior Notes Claims.

8 Neither the first amended disclosure statement nor the prior version disclosed that the senior
9 bondholders are members of the creditors' committee, which has been charged with objecting to the
10 bondholders' claims. They also failed to disclose that Smith, who would continue to serve as Chief
11 Financial Officer and Responsible Individual, was a defendant in the junior bondholders' litigation.

12 On January 22, 2007, creditors Riverside Contracting, LLC, Riverside Claims, LLC, and Argo
13 Partners, Inc. objected to the first amended disclosure statement, raising for the first time before the
14 court the waiver in the VIA settlement agreement of the "Senior Indebtedness" status to which the VIA
15 allowed claim was arguably entitled pursuant to the senior indenture. The objecting creditors asserted
16 that the waiver effectively diluted the distribution to unsecured creditors because VIA otherwise would
17 have accepted an allowed claim in a lower amount. SONICblue Claims LLC ("SB Claims") is a claims
18 trader that has acquired at least \$160,000 of the claims in this case and is the successor in interest to
19 Argo Partners. It admittedly has been interested in acquiring the VIA claim since 2006 to profit from
20 the "Senior Indebtedness" provision of the indenture.

21 Bender states that the committee first learned of the issue from the objections to the disclosure
22 statement. He, at least, had previously been unaware of the connection between the waiver of status in
23 the VIA settlement agreement and the "Senior Indebtedness" provision in the senior indenture. With
24 respect to the committee's involvement in the negotiation of the VIA settlement, Bender explained to
25 the court at the disclosure statement hearing on January 23, 2007:

26 The Creditors' Committee was not a party to that litigation. And there were so many
27 complicated confidentiality agreements that the Committee wasn't even privy to the top-
28 level of confidentiality. So all I would do and Mr. Rankin would do is we would
periodically call primarily the O'Melveny lawyers . . . to get updates from her. . . . We
saw that as our limited role, which is why our fees with respect to that litigation are
minuscule compared to the fee in the case. . . . [T]he Committee . . . was essentially a
client – we were advised that really we were likely to lose on at least the \$70 million
part."

1 This statement appears to be consistent with Bender's declaration in opposition to the motions
2 presently before the court:

3 While counsel to the Debtors (primarily Ms. Uhland of OMM) would periodically
4 provide general status reports to LNBRB (primarily to Mr. Rankin and Ms. Wells who
5 were the partners at LNBRB principally in charge of dealing with the VIA/S3/Intel
6 litigation) and communicate with LNBRB, and did obtain the authority of the Committee
7 (whose active participants at that time were the three Senior Noteholders and the two
8 Matsushita entities) to settle with VIA/S3 by giving them an allowed general unsecured
9 claim of not more than \$25 million, to the best of my knowledge, LNBRB was not a
10 party to any of the confidential settlement discussions that ensued, and LNBRB was not
11 provided with any drafts of the actual VIA/S3 settlement agreement.

12 However, this characterization appears markedly at odds with the following statement in the
13 Seventh Interim Application of LNBRB for Approval of Fees and Reimbursement of Expenses filed
14 October 18, 2006: "LNBRB played a material role in negotiating and documenting the settlement."
15 LNBRB has also requested that the court approve \$102,027.50 in legal fees incurred for services in
16 connection with the VIA litigation.

17 More than six months after the senior bondholders first asserted their claims against PWSP, and
18 only after the United States Trustee filed the motion for disqualification, PWSP filed a supplemental
19 Bankruptcy Rule 2014 disclosure on March 5, 2007 that states:

20 Portside Growth and Opportunity Fund, Ltd., Smithfield Fiduciary LLC and Citadel
21 Equity Fund Ltd. (collectively, the "Senior Noteholders"), are holders of the 7 3/4% Senior
22 Secured Subordinated Convertible Debentures due 2005 (the "Senior Notes"). The
23 Debtors scheduled the claim of the Senior Noteholders for in excess of \$77 million, and
24 each of the three Senior Noteholders filed its own proofs of claim in unspecified amounts
25 related to the Senior Notes. In connection with its Application, the Firm previously
disclosed its substantial pre-petition representation of the Debtors, including for
corporate and securities matters. As part of that representation, the Firm represented
SONICblue in issuing the Senior Notes. As is typical in such financing transactions, the
Firm issued a legal opinion to the Senior Noteholders. Pursuant to letter dated
September 5, 2006, counsel to the Senior Noteholders sought indemnity from the Firm
related to the Senior Notes (the "Demand"). The Firm has rejected the Demand and
declined to provide any indemnity to the Senior Noteholders, and immediately upon
receipt of the Demand the Firm informed counsel for the Creditors' Committee of the
Demand and turned over the analysis of all issues regarding the allowance of the Senior
Noteholders' claims to the Committee. No lawyer in the firm who handled the financing
transaction was involved in the firm's analysis regarding the Senior Noteholders' claims.
Whether the Demand creates any disabling conflict or renders the Firm not
"disinterested" is presently before the Court on motions filed by the U.S. Trustee.

26 PWSP submits that its failure to file this supplemental disclosure earlier was inadvertent.
27
28

LEGAL DISCUSSION**I. The Best Interests of Creditors Mandate the Disqualification of PWSP from its Representation in the Case and the Appointment of a Chapter 11 Trustee.**

Under § 327(a) of the Bankruptcy Code, a debtor in possession may employ attorneys that do not hold an interest adverse to the estate and that are disinterested persons. Thus, to serve as debtor's counsel, counsel must be free of all conflicting interests that might impair the impartiality and neutral judgment that they are expected to exercise. *In re Bellevue Place Associates*, 171 B.R. 615, 626 (N.D. Ill. 1994). "Conflicting loyalties produce inadequate representation, which threatens the interests of the debtor, the trustee and the creditors, and compromises the ability of courts to mete out justice." *In re Tevis*, 347 B.R. 679, 689 (9th Cir. B.A.P. 2006)(discussing California state law to define "adverse interest" under § 327(a)). *See also In re Wheatfield Business Park LLC*, 286 B.R. 412, 417-418 (Bankr. C.D. Cal. 2002). The presence of an actual conflict of interest renders counsel ineligible and constitutes grounds for disqualification from further service. *See In re Plaza Hotel Corp.*, 111 B.R. 882, 889-91 (Bankr. E.D. Cal.)(chapter 11 debtor's counsel disqualified for failing to disclose dual representation of the debtor and of debtor's owner/guarantors), *aff'd*, 123 B.R. 466 (9th Cir. B.A.P. 1990). Section 1104(a)(2) of the Bankruptcy Code creates a flexible standard for appointing a trustee when it is in "the interests of the creditors, equity security holders, and other interests of the estate." *In re Sharon Steel Corp.*, 871 F.2d 1217, 1226 (3d Cir. 1989). It requires the court to weigh competing interests and, under appropriate circumstances, to appoint a trustee regardless of whether "cause" exists within the meaning of § 1104(a)(1). *Id.* Although the United States Trustee has moved for the appointment of a trustee both for cause under § 1104(a)(1) and in the best interests of creditors under § 1104(a)(2), it need only prove one of these two statutory bases. *Id.*

The undisputed facts establish that in April 2002, PWSP issued an opinion letter to SONICblue's senior bondholders. Six months later, SONICblue retained PWSP as its bankruptcy counsel. In March 2003, when SONICblue filed its chapter 11 petition, PWSP submitted its statement pursuant to Fed. R. Bankr. P. 2014 to disclose its connections to "the debtor, creditors and any other interested parties." The statement did not note any connection with the senior bondholders. Aware of its ongoing duty to

1 disclose any conflicts and connections, PWSP filed seven supplemental Rule 2014 disclosure statements
2 through June 2006. None of these supplemental statements mentioned the 2002 opinion letter or any
3 other connection between PWSP and the three senior bondholders. Then, in late August 2006, the three
4 senior bondholders demanded indemnification from PWSP based on the 2002 opinion letter in the event
5 that objections to the bondholders' claims resulted in any losses to the bondholders. This verbal demand
6 was followed with a written demand on September 5, 2006. The next day PWSP transferred its files
7 concerning SONICblue's objections to the bondholders' claims to LNBRB. Six months later, on March
8 5, 2007, after the United States Trustee had filed motions both to appoint a trustee and to disqualify
9 PWSP, PWSP filed its eighth supplemental Rule 2014 disclosure statement that provided a detailed
10 explanation of PWSP's conflict of interest with the senior bondholders.

11 From these facts it is clear that PWSP knew it had a continuing duty to update its Rule 2014
12 disclosures upon learning of any undisclosed connections or conflicts. It is also apparent that as of late
13 August 2006, PWSP knew it had a disabling conflict of interest because it immediately sought the aid
14 of LNBRB in an attempt to resolve the conflict. Yet, PWSP failed to apprise the court of these facts.
15 PWSP's attempt to characterize its failure as inadvertent oversight rings hollow in the face of its
16 previous history of supplemental disclosures. PWSP argued in court that the partner in charge
17 "assumed" a supplemental disclosure had been made, but the firm has not offered any evidentiary
18 foundation for that assumption. The declaration of PWSP partner William Freeman indicates that
19 Freeman had signed several of the earlier supplements and that he typically delegated responsibility for
20 drafting the disclosures. There is no indication, however, that Freeman or any other PWSP partner
21 undertook responsibility, or asked someone else to assume responsibility, for preparing a supplemental
22 disclosure when the actual conflict of interest concerning the senior bondholders arose. PWSP has
23 neither offered proof of any time spent drafting the disclosure nor produced a draft of a disclosure that
24 the firm somehow failed to file. In the end, however, whether intentional or inadvertent, PWSP's failure
25 to disclose this significant and disabling conflict in any reasonable fashion mandates immediate
26 disqualification of PWSP from its representation in this case. Estate professionals must make full,
27 candid and complete disclosures of all facts affecting their eligibility for employment. *In re Plaza Hotel*
28 *Corp.*, 111 B.R. at 883, *aff'd*, 123 B.R. 466 (9th Cir. B.A.P. 1990). See also *Neben & Starrett, Inc. v.*

1 *Chartwell Financial Corp. (In re Park-Helena Corp.)*, 63 F.3d 877, 881 (9th Cir. 1995), *cert. denied*, 516
2 U.S. 1049 (1996)(affirming denial of all fees after debtor's counsel failed to fully disclose circumstances
3 surrounding payment of firm's retainer). The Rule 2014 disclosure requirements are strictly enforced.
4 *Park-Helena*, 63 F.3d at 881-82. Negligent omissions do not excuse failures to disclose. *Plaza Hotel*,
5 111 B.R. at 883. Although PWSP has offered its future service in some more limited capacity, it would
6 not be helpful because the firm's motives in this case would remain subject to attack.

7 The entirety of the undisputed facts also provides clear and convincing evidence that the
8 appointment of a chapter 11 trustee is necessary to restore creditor confidence in the bankruptcy system
9 and to assure that there is no lingering taint from PWSP's representation of the debtor. Neither the court
10 nor the creditors may ever learn why PWSP or Smith, as debtor's responsible individual, failed to bring
11 PWSP's conflict to the court's attention. But, that unanswered question is less important with the
12 appointment of a strong, neutral trustee, who has no connections to any interested party.

13 The presence of a trustee will also alleviate any doubts regarding Smith's role as SONICblue's
14 responsible individual. Both the United States Trustee and SB Claims have questioned whether Smith
15 has relinquished his management responsibilities to PWSP. As the United States Trustee pointed out,
16 Smith's services are part-time at best and SONICblue has no Board of Directors to whom Smith is
17 required to report. Additionally, it is troubling that the Disclosure Statement filed with the court failed
18 to divulge that Smith is a defendant in a lawsuit by SONICblue's junior bondholders that alleges that
19 Smith and SONICblue's former officer and directors breached their fiduciary duties to the company
20 when they authorized the issuance of the senior debentures in 2002. In light of these substantial
21 concerns, the appointment of a trustee is warranted.

22 **II. It is Not in the Best Interest of Creditors to Convert This Case to Chapter 7.**

23 SB Claims has asserted that conversion to chapter 7 is preferable to the appointment of a chapter
24 11 trustee. Althoughs SB Claims relies on several justifications for conversion, in the court's view, the
25 primary reason to convert would be to remove the influence of the creditors' committee from this case.
26 The committee and LNBRB in its filings with the court, support as its "first choice" the retention of
27 PWSP as debtor's counsel while an examiner reviews the pending allegations. Because the facts
28 indicate at least the appearance of impropriety by the committee and LNBRB, SB Claims's concerns

1 in this regard are substantial.

2 During the past year and a half, SONICblue's litigation against VIA and S3 has been the main
3 roadblock to the proposal of a plan and the conclusion of this case. The three senior bondholders were
4 actively represented in the settlement negotiations by Bennett. At the same time, these same senior
5 bondholders were both members and an effective majority of the committee. As committee members,
6 the senior bondholders were and are fiduciaries that bear a duty of undivided loyalty to provide impartial
7 service in the interests of the creditors that they represent. *In re Caldor, Inc.*, 193 BR 165, 169 (Bankr.
8 S.D.N.Y. 1996); *In re Microboard Processing, Inc.*, 95 B.R. 283, 284 (Bankr. D. Conn 1989); *In re*
9 *Mesta Machine Co*, 67 B.R. 151, 156 (Bankr. W.D. Pa. 1986). Because the bondholders appear to have
10 used their position on the committee to insert themselves into the settlement negotiations without
11 revealing a hidden agenda, they may have breached their fiduciary duty to the unsecured creditor body.
12 Whether their motive was simply to save litigation costs for the estate by avoiding future litigation over
13 the priority of VIA's claim, or, instead, to assure a larger return on their individual investments is not
14 known. In fact, as Bennett noted, he had never personally appeared in court until March 19, 2007.
15 During the four years of this case, he has operated in the shadows and, until January 23, 2007, it was
16 not generally known to this court or the creditor body that the three senior bondholders were serving
17 on the committee.

18 SB Claims also expresses concern that LNBRB may have failed to fulfill its role as a watchdog
19 on behalf of the unsecured creditors. First, it appears that LNBRB failed to independently review the
20 settlement agreement between VIA and SONICblue. Although LNBRB asserted in its fee application
21 that it was "intimately" involved in the VIA settlement, in court it has acknowledged that it was
22 essentially a "client" with respect to the settlement negotiations. Similarly, in his declaration on these
23 motions, Bender states that LNBRB received the VIA settlement agreement after it was a "done deal."
24 Rather than review the lengthy document with fresh eyes, Bender called upon O'Melveny & Myers,
25 SONICblue's special litigation counsel, to verbally walk through the settlement's main points. Second,
26 when the actual conflict arose between PWSP and the senior bondholders, SB Claims points out that
27 LNBRB accepted responsibility for prosecuting the objections to the bondholders' claims without
28 considering its own connections to the bondholders and the fact, or at least appearance, that it might also

1 be conflicted. Professionals retained by an official committee of unsecured creditors owe fiduciary
2 duties to the committee and its constituency. *Caldor*, 193 B.R. at 170; *Matter of Celotex Corp.*, 123
3 B.R. 917, 920 (M.D. Fla. 1991); *Mesta Machine Co.*, 67 B.R. at 156. This includes an obligation to
4 represent fairly the interest of the entire creditor class, not just the committee members. *In re General*
5 *Homes Corp.*, 181 B.R. 870 (Bankr. S.D. Tex. 1994); *In re EBP, Inc.*, 171 B.R. 601 (Bankr. N.D. Ohio
6 1994); *Mesta Machine Co.*, 67 B.R. at 156; *Pension Benefit Guaranty Corporation v. Pincus, Verlin,*
7 *Hahn Reich & Goldstein Professional Corp.*, 42 B.R. 960, (E.D. Pa. 1984). It is not clear at this
8 juncture whether LNBRB's handling of the objections of the bondholders was an actual conflict of
9 interest, however, it is worth noting that under § 328(c), unless adequate disclosure is made and prior
10 approval of the court is obtained, committee counsel can be denied compensation if at any time during
11 the representation counsel is not a disinterested person. *Mesta Machine*, 67 B.R. at 157-158. No
12 disclosures were made and no court approval was obtained with respect to LNBRB's acceptance of the
13 claims objections referred from PWSP. Finally, SB Claims suggests, and the record does not dispel, the
14 belief that LNBRB's conduct was a self-interested act to protect its referral sources. A committee
15 controlled by the three senior bondholders hired LNBRB and, of course, has the continuing ability to
16 fire LNBRB. If not an actual conflict, these facts certainly raise questions regarding LNBRB's
17 suitability to vigorously pursue the claims objections on behalf of the estate. Moreover, the protective
18 atmosphere surrounding this close-knit referral circle is reminiscent of the "opprobrious" bankruptcy
19 ring and the cronyism that Congress decried in the legislative history of the Bankruptcy Reform Act of
20 1978. H. Rep. No. 95-595, at 6011 (Sept. 8, 1977).

21 The fact that counsel for claims traders flagged the concerns over potential improprieties or that
22 the claims traders' may be acting in their own self-interest does not detract from the troublesome nature
23 of their arguments. Nevertheless, these very significant concerns are outweighed in this case by the
24 need for the appointment of a strong and disinterested trustee.

25 There have been serious allegations that the case is being run by and for the benefit of counsel.
26 As a result, an active trustee who will formulate an independent strategy and direct its own counsel is
27 critical. It is important to this court that the United State Trustee can tap into a large pool of possible
28 trustees by conducting a nationwide search. In this way, the United States Trustee will have a far

1 greater opportunity to locate a strong trustee with the appropriate qualifications and without connections
2 to this case and this legal community. Additionally, if the case remains in chapter 11, the Bankruptcy
3 Rules require, as a safeguard, that the United States Trustee's application for an order approving either
4 the appointment or the election of a trustee must include a disclosure of all the proposed trustee's
5 connections to the debtor, creditors and other parties in interest. Fed. R. Bankr. P. Rule 2007.1(c).
6 There is no similar disclosure requirement in chapter 7.

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CONCLUSION

9 After careful review of the evidence, consideration of both oral and written argument, the court
10 concludes that the United States Trustee has satisfied its burden of establishing that PWSP must be
11 disqualified from its representation in this case and that the appointment of a chapter 11 trustee is in the
12 best interests of "creditors, any equity security holders, and other interests of the estate." 11 U.S.C.
13 § 1104(a)(2). The issue of disgorgement of fees is reserved for a later hearing after review by the
14 appointed trustee.

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Good cause appearing, IT IS SO ORDERED.

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*** * * END OF ORDER * * ***

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1 Case No. 03-51775-MM

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